



THE ROLE OF FINANCIAL LEVERAGE AND RISK AVERSION IN INDIAN RISK MANAGEMENT PRACTICES

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ABSTRACT

This study explores the critical relationship between financial leverage and risk aversion and its implications for risk management practices in India's corporate and financial sectors. As businesses face increasing uncertainty, strategic decisions regarding capital structure and risk-taking behavior have become central to sustainable growth and financial stability. Financial leverage, while offering the potential for higher returns, introduces substantial risk, especially in volatile environments. On the other hand, risk aversion influences how organizations respond to uncertainty, often dictating their borrowing decisions and investment patterns. In the Indian context, these dynamics are shaped by institutional, cultural, and regulatory factors. This paper examines how firms in India balance the benefits of leverage with the need to mitigate financial exposure, particularly across diverse sectors such as banking, MSMEs, infrastructure, and technology. It highlights emerging trends like the adoption of Enterprise Risk Management (ERM), fintech-driven risk tools, and ESG integration. Additionally, it identifies key challenges such as limited credit access, low financial literacy, and macroeconomic volatility. The study concludes with policy recommendations aimed at fostering a more balanced and resilient approach to financial risk management in India.

KEYWORDS: Financial Leverage, Risk Aversion, Risk Management, Capital Structure, Indian Economy, Corporate Finance, MSMEs, Enterprise Risk Management (ERM)

INTRODUCTION

Risk management has become an integral part of strategic decision-making in both the financial and corporate sectors. With increasing complexity in business operations and heightened global uncertainties, the importance of identifying, assessing, and mitigating risks has grown manifold. Risk management refers to the systematic process of understanding, evaluating, and addressing risks to ensure the achievement of business objectives and the protection of stakeholder interests. In both sectors, the objective is not necessarily to eliminate all risks, but to understand their potential impact and to manage them within acceptable tolerance levels. In the financial sector, which includes banks, insurance companies, investment firms, and other financial institutions, risk management is both a regulatory requirement and a survival necessity. Financial institutions face a wide array of risks including credit risk, market risk, operational risk, and liquidity risk. For instance, banks are vulnerable to the default of borrowers (credit risk), fluctuations in interest rates (market risk), and disruptions in internal systems or processes (operational risk). To mitigate these risks, financial institutions adopt practices such as stress testing, value-at-risk (VaR) models, hedging through derivatives, and stringent credit assessment procedures. Regulatory bodies like the Reserve Bank of India (RBI) have laid out comprehensive guidelines under Basel III norms to ensure that banks maintain adequate capital buffers and follow prudent risk management practices.

In the corporate sector, risk management goes beyond financial concerns and encompasses strategic, operational, compliance,

and reputational risks. Companies are exposed to a multitude of internal and external threats — ranging from supply chain disruptions and regulatory changes to competitive pressure and technological obsolescence. Corporate risk management aims to anticipate these risks and put in place measures that either prevent the risks from occurring or reduce their adverse impacts. For instance, companies may diversify their supplier base to reduce dependency on a single vendor, implement cybersecurity measures to protect data, or engage in scenario planning to prepare for economic downturns. The growing trend of globalization and digital transformation has added new dimensions to risk exposure, making proactive risk management more crucial than ever. Indian companies, especially those operating in volatile markets or those with international linkages, are increasingly embedding risk management into their governance structures. Enterprise Risk Management (ERM) frameworks are gaining traction as they offer a holistic approach to risk across all levels of the organization, aligning risk appetite with strategic goals.

Overall, risk management in both financial and corporate sectors in India has evolved from being a reactive function to a proactive and strategic one. The integration of risk management into corporate governance and decision-making processes ensures not only regulatory compliance but also long-term sustainability and resilience in a rapidly changing environment.

Conceptual Framework

The conceptual framework of this study revolves around understanding the dual concepts of financial leverage and risk aversion, and their integrated role in shaping risk management

practices, particularly in the Indian financial and corporate sectors. Both concepts, though distinct in nature, are interrelated when it comes to decision-making under uncertainty and managing financial exposure. Together, they provide a theoretical lens to examine how organizations balance their growth aspirations with the need for financial stability and sustainability.

Financial leverage refers to the use of borrowed funds to finance the acquisition of assets with the expectation that the income or capital gains from the new assets will exceed the cost of borrowing. It is a powerful tool for enhancing returns on equity, particularly when a firm expects its operational earnings to be higher than the cost of debt. However, increased leverage also amplifies the financial risk, as fixed interest obligations must be met regardless of business performance. Thus, while leverage can accelerate growth, it also raises the likelihood of financial distress in volatile or adverse market conditions. In the Indian context, leverage decisions are influenced by various factors, including capital market conditions, credit availability, regulatory norms, and firm-specific characteristics such as size, age, and profitability.

On the other hand, risk aversion refers to the preference of individuals or organizations to avoid uncertainty and minimize exposure to potential losses. Risk-averse entities tend to prefer safer, more predictable outcomes even if it means accepting lower returns. In corporate finance, risk aversion influences capital structure decisions, investment planning, and operational strategies. For instance, a risk-averse management may opt for equity financing or internal accruals instead of debt to avoid the burden of fixed financial commitments. In India, cultural attitudes towards debt, governance structures, and historical experiences with financial crises also shape the level of risk aversion among business leaders and investors.

The interaction between financial leverage and risk aversion forms the crux of many strategic decisions within an organization. A firm with high leverage but low risk aversion might pursue aggressive expansion, whereas a highly risk-averse firm may remain conservative even with low levels of debt. In India, this dynamic is especially relevant due to the diversity of the business environment — ranging from large conglomerates with sophisticated financial planning to small and medium enterprises that rely heavily on traditional, low-risk approaches to finance.

Furthermore, Indian regulatory bodies such as the Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), and Ministry of Corporate Affairs (MCA) also indirectly shape risk behaviors by influencing leverage norms, capital adequacy requirements, and risk disclosures. These regulatory frameworks not only aim to ensure systemic stability but also guide corporate entities in aligning their financial practices with broader economic goals. This conceptual framework sets the stage for analyzing how Indian firms and financial institutions navigate the complex trade-off between leveraging growth opportunities and maintaining risk tolerance thresholds. Understanding this balance is crucial for crafting effective

risk management strategies that are both growth-oriented and resilient.

Risk Management Practices in India

Risk management in India has evolved significantly over the past two decades, transitioning from a compliance-oriented function to a strategic pillar in both corporate and financial sectors. With increasing globalization, regulatory scrutiny, technological advancement, and market volatility, Indian organizations are recognizing the necessity of implementing structured and forward-looking risk management practices. These practices are now considered essential not only for safeguarding assets but also for ensuring long-term sustainability and competitive advantage.

In the financial sector, risk management is deeply embedded in institutional operations due to the high sensitivity of banks, NBFCs (Non-Banking Financial Companies), insurance companies, and mutual funds to financial fluctuations and systemic risks. Institutions are mandated to follow frameworks like Basel III, which prescribe capital adequacy, stress testing, and market discipline norms. The Reserve Bank of India (RBI) plays a pivotal role in setting risk management guidelines for banking institutions, covering areas like credit risk, market risk, operational risk, and liquidity risk. Financial entities are required to maintain adequate capital buffers, use risk-weighted assets to measure exposure, and implement internal risk models approved by regulatory bodies. In addition, the use of Value-at-Risk (VaR) models, credit scoring systems, internal audits, and early warning signals is growing steadily, particularly among large banks and financial conglomerates.

The corporate sector in India is also increasingly adopting structured risk management practices. While historically Indian firms were reactive in their approach to risk, growing investor expectations, international business operations, and exposure to supply chain disruptions have pushed companies toward adopting proactive Enterprise Risk Management (ERM) frameworks. ERM involves identifying, assessing, monitoring, and mitigating risks across all business functions — including finance, operations, compliance, strategy, and reputation. Indian companies listed on stock exchanges are required by SEBI's Listing Obligations and Disclosure Requirements (LODR) to establish Risk Management Committees and disclose material risk factors in their annual reports. This has led to the formalization of risk registers, risk heat maps, scenario planning, and key risk indicator (KRI) tracking mechanisms in many firms.

In sectors such as infrastructure, pharmaceuticals, information technology, and manufacturing, companies are integrating technology-driven solutions like AI-based analytics, risk dashboards, and automated compliance tools to manage both internal and external risks. The use of hedging instruments (like forwards, futures, options, and swaps) is also prevalent among export-oriented companies to manage currency and commodity risks. Additionally, companies are increasingly investing in cybersecurity risk management, given the rising threat of data breaches, especially in the wake of digital transformation and

the growing reliance on cloud computing.

Another important aspect of India's risk management landscape is the increasing emphasis on Environmental, Social, and Governance (ESG) risks. Climate-related financial disclosures, stakeholder activism, and pressure from international investors are prompting Indian corporations to consider sustainability-related risks as part of their risk assessment processes. ESG risk evaluation is gradually becoming part of enterprise-level strategy, particularly among large companies and multinationals operating in India.

Despite this progress, challenges remain, particularly among MSMEs (Micro, Small, and Medium Enterprises). Many smaller firms in India still lack the resources, expertise, and awareness to implement formal risk management systems. They rely on informal judgment, personal networks, or short-term decision-making, which can increase vulnerability during crises. Bridging this gap through government support, capacity building, and simplified tools is essential to ensure inclusive and effective risk management across sectors.

Overall, risk management practices in India are becoming increasingly sophisticated and institutionalized, particularly in the formal sector. Regulatory frameworks, market demands, and strategic imperatives are pushing Indian organizations to adopt comprehensive risk management strategies. However, continuous education, capacity enhancement, and technological integration are vital to ensure that risk management becomes a universal and value-adding practice across the entire Indian business ecosystem.

Interrelationship Between Financial Leverage and Risk Aversion

The relationship between financial leverage and risk aversion is a critical component of financial decision-making and risk management strategies, particularly in the context of Indian businesses. While financial leverage involves the use of borrowed capital to enhance returns, risk aversion reflects the behavioral tendency of individuals or organizations to avoid uncertainty and potential financial losses. These two concepts are inherently interconnected, as the extent to which an entity utilizes leverage is often a direct reflection of its appetite—or aversion—for risk.

Financial leverage, by its very nature, introduces financial risk into an organization. When a firm takes on debt, it commits to fixed financial obligations in the form of interest and principal repayments, regardless of fluctuations in business performance or profitability. In favorable conditions, leverage can magnify profits and improve return on equity. However, during economic downturns or periods of instability, high leverage can result in increased financial distress and even insolvency. Therefore, the level of leverage an organization is willing to undertake depends largely on how much risk its decision-makers are prepared to tolerate.

Risk aversion influences how decision-makers perceive the trade-off between risk and return. Highly risk-averse managers

or investors tend to avoid excessive debt, preferring internal financing or equity funding even if it offers lower returns. In contrast, those with a higher risk tolerance may aggressively use leverage to pursue growth and expansion opportunities. In India, many family-owned businesses and traditional enterprises exhibit conservative financial behavior, often avoiding high debt levels due to cultural, historical, or generational values that prioritize stability and control over aggressive expansion.

At the macro level, the interrelationship between leverage and risk aversion also plays out in sector-specific dynamics. For instance, Indian startups and venture-backed tech companies, often led by younger and more risk-tolerant entrepreneurs, tend to rely heavily on external funding and are open to leveraging their businesses for rapid scaling. On the other hand, public sector undertakings (PSUs) and companies in heavily regulated sectors like power and infrastructure may adopt a more risk-averse posture, limiting their debt exposure and prioritizing long-term stability over short-term gains.

Empirical evidence from Indian corporate finance literature suggests that firms with higher levels of managerial risk aversion tend to maintain lower leverage ratios. Additionally, the availability of credit, the cost of borrowing, and macroeconomic stability also influence this balance. During times of economic uncertainty, even firms with traditionally aggressive strategies may exhibit more risk-averse behavior by reducing leverage and increasing liquidity reserves.

Regulators in India, such as the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI), also play a significant role in shaping the leverage-risk aversion relationship through policy instruments, interest rate decisions, and capital adequacy norms. These regulatory frameworks can either encourage or discourage borrowing, indirectly influencing firms' leverage decisions based on their risk perceptions.

Overall, the interrelationship between financial leverage and risk aversion is a dynamic and context-sensitive aspect of corporate and financial strategy. In India, this relationship is shaped not only by financial metrics but also by behavioral tendencies, regulatory environment, sectoral characteristics, and broader economic conditions. A nuanced understanding of this interplay is essential for designing effective risk management frameworks that align an organization's financial structure with its risk-bearing capacity and strategic objectives.

Challenges in Balancing Leverage and Risk Aversion

Striking the right balance between financial leverage and risk aversion presents several challenges for Indian businesses, particularly in an environment characterized by economic volatility, regulatory shifts, and varying levels of financial literacy. While financial leverage offers an opportunity to enhance returns, excessive reliance on borrowed capital can increase financial vulnerability. On the other hand, being overly risk-averse may lead to missed growth opportunities, underutilization of resources, and stagnation. This delicate equilibrium is influenced by internal organizational factors as well as external economic and policy conditions.

One of the primary challenges faced by Indian firms is limited access to affordable credit, especially for small and medium-sized enterprises (SMEs). While large corporations may be able to access domestic and international markets for funding, smaller firms often depend on local banks or informal lenders, where credit comes with higher interest rates and stringent conditions. In such situations, even moderately risk-averse businesses avoid debt altogether, thereby missing the potential benefits of financial leverage. This credit asymmetry exacerbates the divide between conservative and growth-driven firms.

Another significant challenge is the lack of financial expertise and analytical capability among many Indian firms, particularly in the MSME segment. Decisions related to optimal capital structure, cost of capital, and debt servicing capacity require robust financial analysis and forecasting. In the absence of such skills or tools, businesses tend to rely on traditional wisdom or intuition, often erring on the side of excessive caution. This results in under-leveraged firms that fail to capitalize on growth opportunities, even in stable market conditions.

Cultural and psychological factors also play a role in shaping risk aversion in India. Many family-owned and closely held businesses prefer retaining control and avoiding debt obligations that may expose them to scrutiny or loss of autonomy. The historical stigma associated with debt, especially if linked to financial distress or bankruptcy, creates a psychological barrier against leveraging. These deeply rooted cultural preferences make it challenging for firms to adopt more dynamic capital structures, even when financially prudent.

From an external perspective, macroeconomic uncertainty and regulatory unpredictability further complicate the balancing act. Fluctuations in interest rates, inflation, currency values, and geopolitical tensions can alter the cost of borrowing and increase repayment risks. Regulatory changes, such as shifts in tax policy, credit guidelines, or industry-specific rules, can also affect leverage decisions. Firms operating in such environments may choose to reduce their leverage buffers preemptively, thereby adopting a more risk-averse stance regardless of internal capacity to manage debt.

Moreover, corporate governance issues and lack of transparency can hinder effective risk-leverage balance. When decision-making is centralized among a few individuals or lacks accountability, firms may either take on unsustainable debt based on short-term ambitions or avoid leveraging altogether due to fear of external intervention. In both cases, the absence of clear policies and risk management frameworks can lead to financial inefficiencies and missed opportunities.

Finally, the increasing emphasis on environmental, social, and governance (ESG) compliance adds another dimension to leverage-risk aversion management. Investors and lenders are now more cautious about funding highly leveraged firms without robust ESG policies, particularly in sectors associated with environmental risk. This places pressure on firms to not

only manage financial risk but also to maintain reputational and compliance standards, which may further influence their risk appetite and capital structure decisions.

Overall, balancing financial leverage and risk aversion is a complex challenge for Indian firms, shaped by structural, behavioral, and regulatory factors. Addressing these challenges requires a multifaceted approach—enhancing financial literacy, improving access to credit, building strong governance mechanisms, and fostering a culture of informed risk-taking. Only then can Indian businesses leverage capital efficiently while safeguarding their long-term financial health.

Emerging Trends and Best Practices

In recent years, the financial and corporate landscapes in India have witnessed significant transformation in how firms approach financial leverage and risk aversion. As companies strive to remain competitive in a volatile global economy, emerging trends and best practices are shaping more sophisticated and balanced risk management strategies. These developments are being driven by technological innovations, regulatory reforms, evolving investor expectations, and a growing emphasis on sustainability and governance.

One of the most prominent emerging trends is the adoption of technology-driven risk management tools. Many Indian firms are increasingly leveraging advanced data analytics, artificial intelligence (AI), and machine learning (ML) to predict financial risks and optimize leverage decisions. These technologies allow for real-time monitoring of financial indicators, early detection of distress signals, and the simulation of various leverage scenarios under different market conditions. With cloud-based enterprise resource planning (ERP) systems, firms can now integrate financial planning, debt servicing schedules, and risk mitigation strategies across departments, making risk management more agile and data-informed.

Another critical trend is the integration of Enterprise Risk Management (ERM) frameworks within corporate governance structures. ERM offers a holistic view of all potential risks—financial, strategic, operational, and compliance-related—and ensures that leverage decisions are aligned with the organization's overall risk appetite. Indian companies, particularly those listed on stock exchanges, are now required by SEBI regulations to establish formal Risk Management Committees. These committees are tasked with evaluating leverage levels, overseeing risk exposure, and ensuring alignment with long-term corporate goals. This institutionalization of risk oversight marks a move from reactive to proactive risk management.

Financial discipline and capital structure optimization have also emerged as best practices among progressive Indian firms. Companies are now focusing on maintaining an optimal mix of debt and equity by carefully analyzing their cost of capital, debt servicing ability, and market conditions. Debt is no longer seen merely as a funding source but as a strategic tool to enhance shareholder value when managed prudently. Organizations are adopting dynamic capital structures that adjust to business cycles—taking on higher leverage during periods of growth

and deleveraging during downturns to minimize risk exposure.

In addition, ESG (Environmental, Social, and Governance) considerations are becoming integral to financial decision-making. Institutional investors, lenders, and global stakeholders increasingly scrutinize companies' ESG practices, especially when they are highly leveraged. Firms that demonstrate strong ESG risk management are often perceived as more resilient and are more likely to secure funding at favorable terms. This has led to a growing trend of linking ESG compliance with capital access and financial planning, making it an essential factor in managing risk and leverage.

Financial inclusion and credit ecosystem reforms are also contributing to better leverage-risk alignment. Initiatives such as the Pradhan Mantri Mudra Yojana (PMMY), credit guarantee schemes for MSMEs, and the growing fintech ecosystem have improved access to formal credit for small businesses. This allows previously under-leveraged firms to responsibly utilize debt while remaining cautious about repayment capacity. Fintech platforms are also promoting transparency, offering alternative credit scoring models, and providing tailored financial products that balance leverage and risk according to the borrower's profile.

Lastly, capacity building and awareness programs are being recognized as essential best practices. Industry associations, business chambers, and financial institutions are conducting regular workshops, certification programs, and financial literacy initiatives aimed at educating entrepreneurs and managers on the effective use of leverage and the importance of managing financial risks. These initiatives are especially vital in tier-2 and tier-3 cities, where many firms still operate based on traditional, informal financial management systems.

In summary, the landscape of financial risk management in India is rapidly evolving. Emerging trends such as technology integration, ESG alignment, regulatory oversight, and improved credit access are enabling firms to manage financial leverage more strategically while respecting their inherent risk aversion. By adopting these best practices, Indian enterprises are better positioned to build financially resilient and growth-oriented businesses in an increasingly uncertain global environment.

Policy Implications and Recommendations

The growing complexity of financial markets, coupled with the diverse nature of Indian businesses, necessitates robust policy support to effectively balance financial leverage and risk aversion. Policymakers play a critical role in shaping a financial ecosystem that encourages responsible borrowing while fostering a culture of informed risk-taking. The current trends and challenges in India highlight the need for integrated, forward-looking policies that not only regulate leverage levels but also enhance institutional and managerial capacity to manage risks prudently.

One major policy implication is the need to enhance access to affordable and structured credit, especially for micro, small, and medium enterprises (MSMEs). Despite being key drivers

of employment and GDP, many Indian MSMEs remain under-leveraged due to difficulties in accessing formal finance. Policymakers should expand and refine credit guarantee schemes, incentivize banks and NBFCs to lend responsibly, and promote fintech-enabled lending platforms that can assess borrower risk more effectively. Simplifying documentation, improving credit rating systems, and creating borrower-friendly digital ecosystems can reduce credit friction and encourage businesses to adopt a healthy level of financial leverage.

Another critical recommendation is to promote financial literacy and risk awareness among entrepreneurs, especially in semi-urban and rural areas. A lack of understanding about the trade-offs between leverage and financial risk often leads to overly cautious behavior or, conversely, reckless borrowing. Government bodies, in collaboration with industry associations, academic institutions, and banks, should launch widespread financial literacy campaigns. These programs must focus on capital structure planning, debt servicing, risk-return trade-offs, and the use of financial instruments for risk mitigation. Such initiatives would empower business leaders to make informed and balanced financial decisions.

There is also a strong case for strengthening regulatory frameworks and corporate governance norms related to risk management. Regulatory authorities like SEBI, RBI, and MCA should continue to mandate the formation of Risk Management Committees and the disclosure of risk exposures in annual reports. Furthermore, regulators should consider developing sector-specific risk management guidelines, particularly for high-risk industries such as infrastructure, real estate, and financial services. Encouraging the adoption of Enterprise Risk Management (ERM) frameworks across firms of all sizes can standardize risk practices and integrate them into core business strategies.

From a macroeconomic perspective, policymakers must maintain a stable and predictable financial environment that encourages prudent leveraging. Volatility in interest rates, inflation, and currency exchange can influence firms' borrowing decisions and amplify perceived financial risks. Sound monetary and fiscal policy coordination is crucial to providing economic stability, which, in turn, supports long-term planning and sustainable capital structuring among Indian firms.

Another recommendation is to encourage innovation in risk assessment and management tools. Public-private partnerships can help develop affordable, tech-driven solutions for financial forecasting, debt management, and risk evaluation. Support for R&D in financial technologies (fintech), the use of AI-based risk analytics, and blockchain for transparency in financial reporting can make risk management more effective and accessible.

Lastly, integrating environmental, social, and governance (ESG) risk frameworks into the broader financial policy landscape is essential. Government and regulators must provide clear ESG disclosure standards and offer incentives to companies that incorporate sustainability into their risk assessment processes.

Since investors and creditors are increasingly ESG-conscious, aligning financial leverage decisions with ESG goals can enhance both creditworthiness and investor confidence.

Overall, achieving an optimal balance between financial leverage and risk aversion in India requires coordinated efforts across policy, regulation, education, and technology. By fostering a supportive financial ecosystem, enhancing managerial capabilities, and ensuring regulatory clarity, India can empower its businesses to pursue growth while effectively managing financial risks. These policy actions will not only strengthen corporate resilience but also contribute to broader financial stability and sustainable economic development.

CONCLUSION

The interplay between financial leverage and risk aversion plays a pivotal role in shaping effective risk management practices in India. As organizations strive to optimize their capital structures, they must navigate the delicate balance between seizing growth opportunities through leverage and maintaining financial stability through risk-averse strategies. In the Indian context, this balancing act is particularly complex due to diverse business profiles, varying levels of financial sophistication, and evolving regulatory frameworks.

While financial leverage can enhance returns and support expansion, its misuse or overuse can lead to heightened financial distress, especially in times of market volatility. Conversely, excessive risk aversion, often driven by cultural, psychological, or informational barriers, can result in underinvestment and lost growth potential. Therefore, a strategic and informed approach to managing leverage—guided by sound risk assessment—is essential for long-term success.

India's corporate and financial sectors have made significant progress in adopting modern risk management frameworks, aided by regulatory reforms, technological advancement, and increasing awareness of best practices. However, challenges remain, especially among MSMEs and traditional businesses that lack access to affordable credit and risk management tools.

Moving forward, it is imperative that businesses, regulators, and policymakers work collaboratively to foster a financial ecosystem that promotes responsible borrowing, encourages innovation in risk mitigation, and supports capacity building. With the right balance between leverage and risk aversion, Indian enterprises can enhance their resilience, improve financial performance, and contribute meaningfully to the country's economic growth and sustainability.

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